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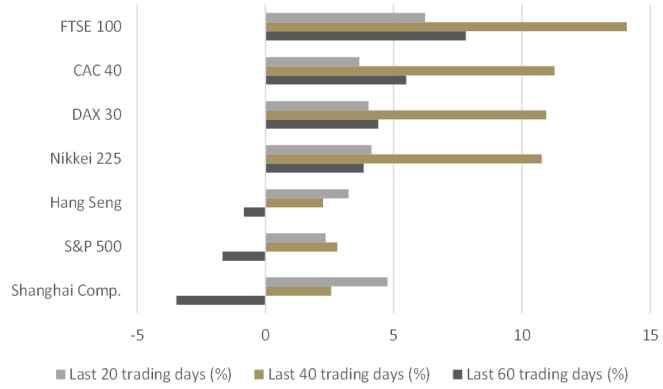
Update - May 2018

Global Factors

Markets have been bumpier in early 2018 mainly due to macro themes such as the fear of rising inflation and increasing trade-war concerns. Nevertheless, leading global economic indicators have improved significantly since the summer of 2016 and are now at their best levels in years, consistent with robust growth.

There was some good news for UK consumers during April, as it was announced that wage growth had reached the fastest pace seen in more than three years. In addition, the latest labour market data was also encouraging. A total of 197,000 jobs were created in the three months to March, the strongest gain since the end of 2015. And the fact that the FTSE100 has been the best performing major equity market over the past three months, adds at least some weight to the idea that few expect the first quarter's disappointment to be the start of a new trend (see Chart 1). It came as no surprise that the MPC delayed raising interest rates earlier this month, as a consequence of weak economic growth and inflation falling further than expected in March. However, it still appears to be a question of when, rather than whether, UK rates will next rise.

1.0 Changes in selected major market indices (%)



Source: Thomson Reuters

An Overview

Having returned with a vengeance in the first quarter, volatility persisted through much of April. Geopolitical headlines continued to play a significant role in unsettling investors, particularly the prospect of a "trade war" between the US and China alongside an escalation of tensions between the US and Russia over the situation in Syria.

UK commercial property has seen a fall in transactional activity over the first few months of the year. However, the attractive relative risk return offered by UK commercial property compared to other asset classes means that demand remains high.

May Top 5

1. Good news for UK consumers as wage growth reaches its fastest pace in more than three years
2. Uncertainty remains over the next interest reate rise due to an unexpected fall in inflation
3. Retail remains in the spotlight as Mothercare becomes the latest chain to annnounce closures
4. Despite Brexit ambiguity, there remains little evidence of the feared outflow of office jobs from central London
5. Supply in most regional office markets is relatively constrained, providing a favourable outlook for rental values going forward

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Meanwhile, the US economy shows few signs of slowing. Business surveys suggest that GDP growth will strengthen from 2.3% annualised in the first quarter, to perhaps 3% in the second. Consistent with that both industrial production and retail sales, which recorded gains of 0.7% m/m and 0.4% m/m respectively, suggest that US activity levels strengthened in April. However, the flip side of all that is that market interest rate expectations have hardened. Financial markets are now pricing in between four and five rate rises before the end of 2019. Concerns are therefore beginning to surface that the accompanying movement in market interest rates (10-year treasury yields are back above 3%), will act as a growing headwind to the US recovery in 2019.

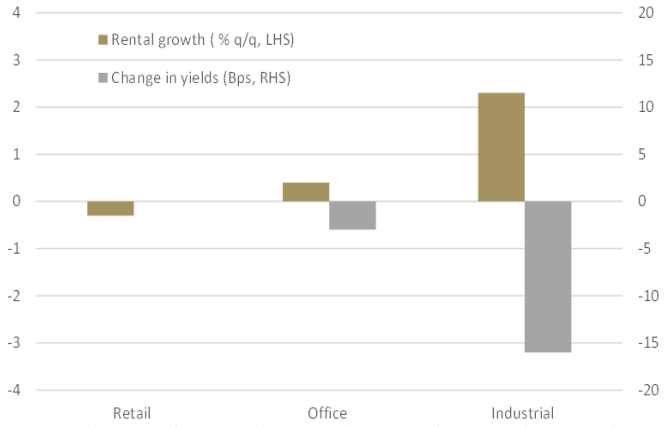
In Europe the recovery continues to be underpinned by the improvement in the labour market. The eurozone unemployment rate fell to 8.5% thanks to significant declines in several countries, including Italy, France and Spain. A stronger labour market is supporting consumer confidence, with retail sales growing at a healthy 1.8% rate, year-on-year (y/y). The first-quarter European Central Bank (ECB) lending survey was strong, suggesting that accommodative monetary policy is still providing a significant tailwind to growth. As such, the ECB is likely to err on the side of caution, winding down asset purchases only slowly and keeping interest rates at current levels until late 2019. However, the emerging coalition between Lega and the Five Star Movement in Italy, and their plans to overturn EU-imposed austerity, have re-ignited fears that another crisis in the euro-zone may be just around the corner.

Property Overview

The available data continues to point to a polarised market in the early stages of 2018. At one end of the spectrum, the industrial sector continues to set the pace, while the retail sector remains in the doldrums.

According to CBRE, for example, prime shop rents fell by 0.3% q/q during the first quarter while yields were unchanged. In contrast, prime industrial rents enjoyed a 2.3% q/q gain and yields in the sector dropped by 16bps (see Chart 2). Offices occupied the middle ground, with both rental growth and yield movements combining to produce a modest uplift to capital values.

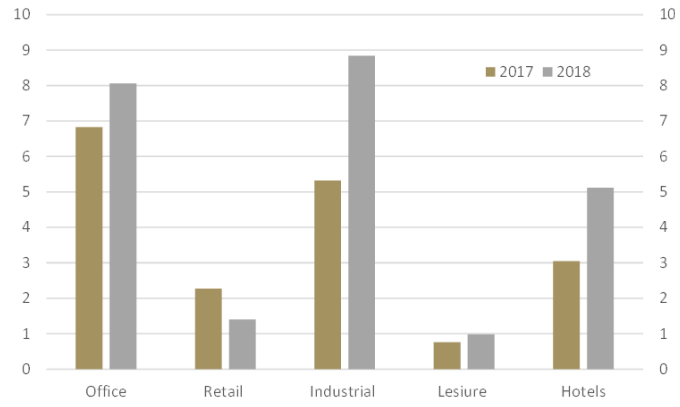
2.0 Change in prime rents and yields (Q1 2018)



Source: CBRE

Investment data paints a consistent picture. Viewed in aggregate, the combined value of investment deals for UK property assets is only 2.3% lower than the same period of 2017. But within that total, investment in office and industrial property has risen, while investment in retail property has slumped by almost 40% (see Chart 3).

3.0 Cumulative investment by main sector (Jan to April - £bn)



Source: Property Archive

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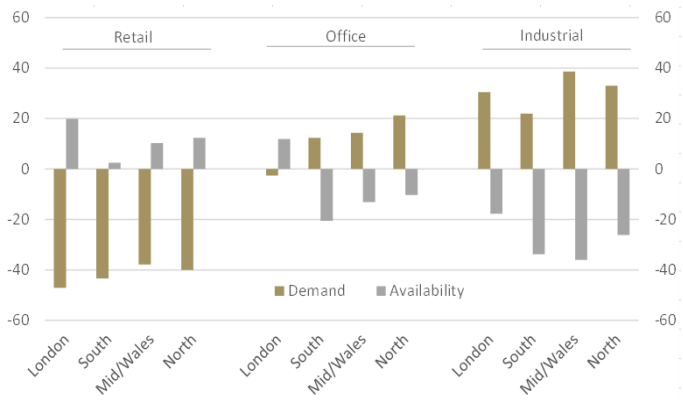
London Property Market

The same survey paints a very similar picture of occupier market trends in London. A net balance of 47% of surveyors report that demand for retail space is falling, pushing up availability and sharply dampening expectations for retail rental values over the coming year.

Meanwhile, demand for industrial space is reported to have risen in each of the past 21 quarters, depressing availability and keeping rental expectations elevated. And in the office sector, the dip in demand that was reported in 2017 appears to be easing. Development starts have also continued to drop back in the early stages of 2018, meaning that rental values are expected to remain stable for the foreseeable future. That survey evidence also appears consistent with the fact that there is still little evidence of the feared outflow of office jobs from Central London, despite the lack of clarity over Brexit.

The message from the RICS survey also sits comfortably with the latest agency reports on conditions in Central London. For example, CBRE report that, at 3m sq.ft., office take-up in the first four months of the year has been almost identical to the comparable period of 2017. Moreover, at 14.2 m sq.ft., availability is still about 5% lower than the average level seen over the past decade.

4.0 Surveyors reporting higher occupier demand and availability (% Bal.)

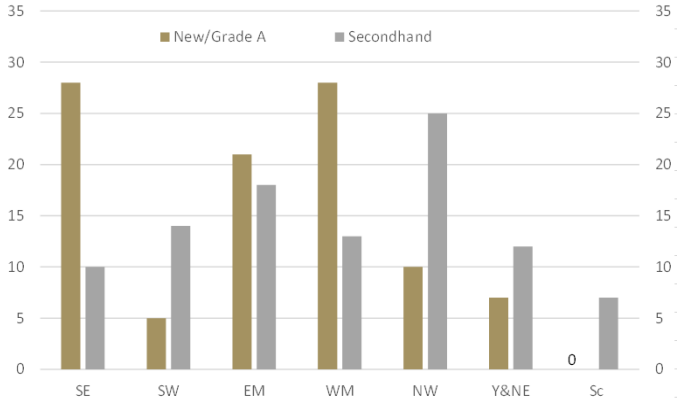


Source: RICS

That said, the RICs survey is a measure of market momentum, not a measure of the absolute strength of demand or availability. And for the logistics market it is still the case that activity is highly concentrated in the South East. In the year to Q1, CBRE report that 54% of take-up of Grade A warehouse space, exceeding 100,000 sq.ft., was accounted for by the South East - more than the East Midlands, West Midlands and North West combined.

That said, a regional breakdown of space under offer strongly suggests that demand is rapidly becoming more geographically balanced (see Chart 5).

5.0 Industrial space under offer (units over 100,000 sq.ft. - % of total)



Source: CBRE

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Sector Spotlight

Regional Offices

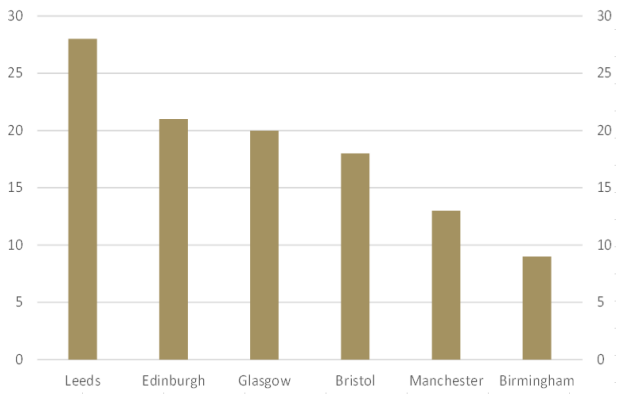
A closer look at recent developments in the regional office sector does nothing to dampen the impression of a market that is gathering traction. For example, Lambert Smith Hampton report that, bolstered by Legal & General's purchase of the India Buildings in Liverpool for £125m, and Aviva Investors' purchase of Two New Bailey Square in Manchester for £113m, more than £1bn of regional office property changed hands in the first quarter of 2018. In Manchester and Birmingham, CBRE reported that investor demand was sufficiently strong to push prime office yields below 5%.

Overseas investors have recognised the potential for growth in regional locations (32% of investment volumes in 2017 according to GVA) and have taken advantage of a weaker Sterling. Domestic buyers have dominated the market in Q1 (90% of volumes) led by the UK institutions and investment managers. With uncertainty in the short-term future and investors leaning to low risk grade A buildings let to strong covenants with secure long-term income, pricing on these core assets will continue to harden as demand exceeds supply.

While there remains a weight of money targeting secondary markets and more opportunistic investments, a pricing mismatch between vendors' and purchasers' expectations continues to result in a lack of opportunity and deal flow in this area. Where there is a strong occupational market and a shortage of grade A stock, there will continue to be interest in secondary assets with refurbishment opportunities.

Investor appetite for regional office property is being underpinned by robust levels of occupier demand, at least if the South East is excluded. But even here, despite a sharp quarter on quarter dip, take-up in the main M3, M4 and M25 office markets was no worse than the average for this time of year. Looking beyond the South East, however, the picture was more favourable, with take-up in Q1 2018 at least 9% higher than a 10-year average in Birmingham, Manchester, Bristol, Glasgow, Edinburgh and Leeds (see Chart 6).

6.0 Office take-up in Q1 2018 (difference from 10-year average - %)



Source: Lambert Smith Hampton

There is continuing employment growth across the regional cities, which are benefitting particularly from the reorganisation of the government estate, together with ongoing regeneration and investment in local and regional infrastructure. These markets have also been helped by the net loss of grade B space to alternative uses.

Of course, there is no guarantee that such levels of occupier demand will be sustained. That said, the economic fundamentals look sound and there is also some tentative evidence that a shift in occupier attitudes may be getting underway. For example, although no firm plans have been announced, it has been reported that advertising giant WPP is considering moving its headquarters out of London to try and reduce the high levels of staff turnover and, in particular, the number of skilled staff who defect to join a rival.

In any case, supply in most regional office markets is relatively constrained. Knight Frank have reported that development pipelines typically equate to less than one year of take-up in most of the larger city office markets, far less in many cases. And to date at least, there has been little evidence of a material supply response, with most reports indicating that regional office development starts are fairly stable. That suggests that the outlook for rental values and vacancy should be pretty favourable for some time yet.

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The current optimism of investors to the regional office sector, along with the weight of money, scarcity of institutional grade supply and yield differential with London will continue to support investment volumes this year. The regional cities continue to provide a yield advantage over London. Prime yields range from 4.75% in Birmingham and Manchester, to 5.75% and 6% in Newcastle and Liverpool. There is therefore 100 basis point differential between the 'Big Nine' cities and a further 150 basis points over London's West End.

UK institutions are expected to remain the dominant buyer over the next 12 months and returns will be dominated by income return. Although rising interest rates will reduce the gap between gilt yields and regional property yields a little, the gap will remain historically wide and so commercial property will continue to look attractive.

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